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## CHAPTER: Asset Quality

### SECTION: Real Estate Owned and Other Repossessed Assets

### Section 251

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#### INTRODUCTION

When a savings association repossesses property, there is a distinct possibility of loss on the liquidation of the property otherwise the borrower would not have defaulted. Real estate owned (REO) is real property that a savings association holds as a consequence of defaults on loans. It is typically a poor or non-earning asset and a savings association's acquisition of a limited amount of REO is an unavoidable result of normal business operations.

REO includes real estate acquired in the following ways:

- Real estate in judgment.
- Real estate acquired through foreclosure.
- In-substance foreclosures.<sup>1</sup>
- Real estate acquired through deed in lieu of foreclosure.
- Any real property exchanged for foreclosed real estate.

If a question arises as to whether the savings association should report a parcel as REO, you should look to economic substance rather than to the legal form in which the property is held.

Other repossessed assets are non-real estate property the savings association takes possession of to satisfy some or all of a borrower's debt.

The usual types of other repossessed assets include the following properties:

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<sup>1</sup> If the savings association does not expect full payment of all amounts due for an impaired, collateral-dependent loan, the savings association should measure the impairment based on the fair value of the collateral less costs to sell. Pursuant to SFAS No. 114, the lender should report the impaired loan as an in-substance foreclosure if it has physical possession of the collateral. Other collateral-dependent loans that the lender does not possess remain categorized as loans.

- Personal property: vehicles, mobile homes, boats, airplanes, etc.
- Commercial goods: equipment, furniture, fixtures, inventories, accounts receivable, lease receivables, etc.
- Investments: stocks, bonds, certificates of deposit, etc.
- Other: intangible assets, cash surrender value of life insurance policy, etc.

Throughout this Section, we use the terms foreclosure and repossession (and other forms of those terms) interchangeably.

#### Supervisory Concerns

An increase in a savings association's REO and repossessed assets portfolios should serve as red flags to both you and management. Increases in these portfolios may indicate deteriorating economic conditions, lax adherence to loan underwriting standards, or deficient loan administration. The historical absence of REO may be indicative of overly restrictive loan underwriting criteria or a lax foreclosure policy.

You should perform the following steps:

- Review the savings association's internal asset review program.
- Evaluate the adequacy of internal controls.
- Interview management concerning:
  - the detection of potential problem credits.
  - the effectiveness of resolutions (workouts) and collection of problem loans.

The savings association should evaluate the likelihood of repossessing an asset for all seriously delinquent loans. The savings association should also consider other alternatives to repossession. Prior to foreclosure or repossession, management should check with the proper authorities to verify the existence of a valid recorded lien. At that time, the savings association should determine the market value of the collateral. The savings association should also obtain sufficient insurance coverage on the asset after the savings association takes possession.

#### *Appraisals*

In accordance with 12 CFR §560.172, savings associations must appraise each parcel of REO at acquisition, consistent with the requirements of Part 564. A savings association must appraise each parcel of real estate owned at the earlier of an in-substance foreclosure or at the time of the savings association's acquisition of the property. Thereafter, prudent management policy dictates the timing of appraisals. The regional director (or designee) may require subsequent appraisals if they deem necessary under the circumstances. Savings associations must carry REO on the books at the lower of recorded cost or fair value less costs to sell. Therefore, OTS does not require an appraisal upon disposition of the property; however, the savings association's policies may require one.

#### *Accounting at Foreclosure*

Statement of Financial Standards No. 15 (SFAS 15), SFAS No. 114, and SFAS No. 121 generally provide the accounting treatment for REO including in-substance foreclosures.

Savings associations must initially record foreclosed assets deemed held for sale at the lower of one of the following amounts:

- Recorded investment (that is, carrying value before deduction for valuation allowances) in the loan.
- Fair value less costs to sell the foreclosed asset.

The costs to sell an asset include the estimated incremental direct costs to transact the sale of the asset. This includes such costs as broker commissions, legal and title transfer fees, and closing costs. Costs to sell generally exclude insurance, security service, and utility costs.

Upon foreclosure (including in-substance foreclosure), the savings association must compare the recorded investment in the loan (carrying value before deduction for valuation allowances) to the fair value less costs to sell the foreclosed property.

The savings association must classify as Loss and charge off any amount in excess of recorded investment over fair value less costs to sell. The savings association cannot represent this Loss classification by a valuation allowance.

Savings associations must expense, as incurred, legal fees and direct costs of acquiring title to foreclosed assets.

#### **Hold or Sell Decision**

Once a savings association acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property or sell it (possibly in an unfavorable market). A primary consideration when selling the asset is whether the savings association will have to make a loan to facilitate the sale. The savings association must consider the overall cost if it regains the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the savings association initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the savings association has

sacrificed any income it could have received from an interim use of the property.

In making the decision when and if to sell the repossessed property at the least cost to the savings association, management should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property “as is.”
- Cost of completing, restoring, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period:
  - Insurance
  - Physical security (fencing, security service, etc.)
  - Maintenance (mowing, utilities, structural repair, etc.)
  - Intangible (lost goodwill, etc.).
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the savings association, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (discount future and probable cash flows to present value).
- Anticipated appreciation or depreciation during the holding period.
- Benefit when property sold at end of holding period (discount proceeds to present value, determine yield based on current market rates).
- Benefit of interim use of the property in a lease or rental arrangement.

- Requirements imposed by 12 CFR § 567.1 to dispose of equity investments in real property within a specified time period to maintain capital rule treatment as REO. This period is generally five years unless OTS approves a longer period.

The above analysis should assist management in making an informed decision on the disposition of the savings association's REO and repossessed assets.

#### *Five-Year Holding Period*

OTS defines an equity investment in 12 CFR § 567.1 to exclude real property the savings association obtained in satisfaction of a debt or acquired under a judgment or mortgage. This is true if the savings association does not intend to hold the property for real estate investment purposes and plans to dispose of the property within five years. If requested, OTS may approve a longer period. OTS considers the extension of time a supervisory decision. For OTS to consider such extensions, the savings association should address the following items in its request letter:

- The term of the extension and the reason for the request.
- Whether the savings association, in good faith, tried to dispose of the property.
- How the accountants regard the property for GAAP purposes.

#### **Internal Asset Review**

As a sound banking practice, savings associations should conduct periodic reappraisals and reassessments of REO and other repossessed assets. We noted exceptions to this requirement in the Appraisals section presented earlier. The classification of assets regulation does not mandate that the institution automatically classify all foreclosed property. Handbook Section 260, Classification of Assets, discusses situations where savings associations need not classify REO. REO is sometimes an unsound asset even

when recorded at fair value. The savings association's acquisition of the property normally indicates a lack of demand. As time passes without disposition, the lack of demand becomes more apparent and the quality of the asset becomes more doubtful.

The savings association should consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting your evaluation. For instance, if a developed parcel of REO is receiving steady cash flows at a market yield, an adverse classification may not be necessary.

#### *Accounting after Foreclosure*

For periodic evaluations of REO for impairment, *after* foreclosure, the savings association must classify as Loss, and charge off or represent by a specific valuation allowance, any excess of recorded investment over current fair value less cost to sell. Savings associations must deduct valuation allowances from the recorded investment to arrive at carrying value.

OTS policy does not automatically require general valuation allowances (GVA's) on REO. The institution should establish GVAs when it is likely to experience losses when disposing of REO or is likely to incur holding costs that are not reflected in the fair value estimate. The savings association should base the level of any required GVAs on REO on its historical net loss experience, adjusted for current conditions and trends.

OTS does not recognize loss allowances (general or specific) on foreclosed (REO) assets held for sale as a component of Tier 1 (core) or Tier 2 capital. The regulatory capital standard only includes GVAs related to loans and leases in Tier 2 capital up to a certain limit.

#### **Real Estate Owned (REO) Workouts**

Management must assess the level of in-house expertise available to manage REO workouts. Management should consider the possibility of looking outside the association for the necessary

level of expertise. This should include recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

Management is responsible for reviewing the economic merits of out-sourcing REO disposition plans. If any savings association identifies any regulatory issues of concern during its process of selecting an outside REO workout program, it should raise these issues with the appropriate examination or supervisory personnel. They will provide advice on whether the vendor's proposal conforms with regulatory procedures and safe and sound practices. Savings associations should be aware that OTS neither approves nor endorses specific REO workout proposals. Savings associations should bring to OTS's attention any representations by any organization to the contrary.

#### **Accounting for Sales of Real Estate**

Accounting for the sale of real estate requires the determination of the following two issues:

- The point at which a sale actually occurs.
- How the savings association recognizes the gain on the sale.

When an association does not recognize a sale they should classify the asset as REO. Generally, the savings association may consummate a sale once the following events occur:

- The terms of a contract bind the parties.
- The exchange of all consideration.
- The seller, if responsible, arranges for any permanent financing.
- The parties perform on all conditions precedent to the closing.

See SFAS 66, Accounting for Sales of Real Estate, paragraph (6).

*Gains*

Generally, a savings association does not recognize a gain for accounting purposes if the seller retains some type of continuing involvement in the property without transferring the risks and rewards of ownership to the buyer. Continuing involvement includes any of the following situations:

- The seller makes an obligation to repurchase the property.
- The seller retains an equity interest in the property.
- The seller guarantees an investment return to the purchaser.
- The seller must initiate or support operations or continue to operate the property at the seller's own risk.

If, after the transaction, the savings association retains some type of continuing involvement in the property, the transaction may not qualify for gain recognition. The savings association should defer any gain and credit to an account descriptive of unearned gain on the sale of real estate.

Savings associations must account for all gains under generally accepted accounting principles (GAAP). SFAS No. 66 specifies the amount and timing of gains the seller of real estate may recognize when the sale depends upon the seller's continuing involvement and retention of risks. The savings association may recognize all gains at the time of sale as long as the sale meets the following conditions:

- The savings association did not finance the sale.
- The savings association has no continuing involvement with the property.

In the more common situation where the savings association makes a loan to facilitate the sale of REO, the savings association may recognize the

full gain if the sale meets all of the following conditions:

- The savings association and buyer consummate the sale.
- The buyer has adequate initial and continuing investments that demonstrate a commitment to pay for the property.
- The seller's receivable is not subject to future subordination.
- The seller transfers to the buyer the usual risks and rewards of ownership in a transaction that is, in substance, a sale and does not have a substantial continuing involvement with the property.

Loans to facilitate the sale of real estate do not fall under the loans to one borrower rule if the association takes a purchase money mortgage note from the purchaser and meets the following two conditions:

- The savings association does not advance any new funds to the borrower.
- The association is not in a more detrimental position as a result of the sale.

Handbook Section 211 describes circumstances where a savings association may use its salvage powers to exceed the Loans to One Borrower rules.

*Losses*

GAAP requires that if the sale of REO results in a loss, the savings association shall account for the loss in the period it sustained the loss. It is an unsafe and unsound practice for a savings association to fail to recognize losses from the sale of REO where the price is inflated above the market value. The inflated price may be a result of favorable terms the savings association provided in a loan to facilitate. GAAP requires discounting sales prices to reflect market interest rates for loans of similar terms and risk. You

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should take exception and prompt supervisory action when savings associations finance significant amounts of their REO by loans at interest rates substantially below the current market rates.

No. 15

Accounting By Debtors and Creditors for Troubled Debt Restructurings (amended, in part, by SFAS No. 114 and SFAS No. 121).

### REFERENCES

No. 66

Accounting for Sales of Real Estate (amended, in part, by SFAS No. 121)

### Code of Regulations (12 CFR)

§ 560.30 General Lending and Investment Powers

No. 114

Accounting by Creditors for Impairment of a Loan (amended and superseded, in part, by SFAS No. 118) (Amends SFAS No. 5 and SFAS No. 15, in part)

§ 560.93 Lending Limitations

§ 560.100-101 Real Estate Lending Standards

§ 560.160 Asset Classification

§ 560.172 Re-Evaluation of Real Estate Owned

No. 118

Accounting by Creditors for Impairment of a Loan –Income Recognition and Disclosures (amends and supersedes, in part, SFAS No. 114)

§ 567.1(i)(4) Definition of Equity Investment in Real Property

### Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 121

Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (amends, in part, SFAS No. 15 and SFAS No. 66)

No. 5 Accounting for Contingencies (amended, in part, by SFAS No. 114)